April 22, 2020

The first quarter of 2020 was a truly remarkable period for U.S. equity markets. Through mid-February, the coronavirus was viewed as a short-term concern isolated to China, and possibly those heavily dependent on a Chinese supply chain. U.S. markets remained resilient, pushing higher until peaking on February 19. However, as the virus spread to other countries, including the U.S., it has become clear that the impact will be felt globally with potentially staggering costs in both economic and, more importantly, human terms. Since February’s highs, the U.S. economy experienced an unprecedented shutdown while equity markets experienced equally dramatic volatility along with the swiftest decline in many decades. Thus far, the levels reached on March 23 have marked the bottom for the major U.S. indexes, and we have since witnessed a very sharp rally into quarter end which has now continued into April (as we write).

With this general backdrop, we view the Fund’s year-to-date performance to be disappointing and believe it deserves more color. First, we are pleased that the short book contributed nicely to performance, down approximately 440 basis points more than the Russell 1000 Index. However, overall portfolio performance in Q1 was disappointing as the long side underperformed the market. Notable weakness in financials, travel-related businesses and other cyclical companies—particularly those with direct or indirect exposure to the energy complex—has undoubtedly weighed on Fund performance. Also, because the relative outperformers (generally growth and “low-vol” defensives) have been areas that we felt recently represented poor value propositions, we generally had modest exposure there.

During the quarter, growth stocks continued to dominate value stocks, with the Russell 1000 Growth Index outperforming the Russell 1000 Value Index by more than 1,200 basis points. This “growthy” type of market has been the case for years now—in fact, over the past five years (ended March 31, 2020), the Russell 1000 Growth Index outperformed the Russell 1000 Value Index by nearly 8.5% annualized. This remarkable level of outperformance has created a more challenging environment for us given our value bias. Our intrinsic value investment philosophy leads us to businesses selling at a discount to our fair value estimate. That can mean occasionally we find companies that are typically thought of as growth companies which fit that bill (e.g., Alphabet, Microsoft and Facebook, which have each been significant positions in the portfolio and remained large weightings as of quarter end). We strongly believe our philosophy allows for a level of flexibility that is a key advantage for us. Positively, it often takes a recessionary type of environment to catalyze a change in market leadership, and we believe it is quite likely that the next five years will see a markedly different growth vs. value dynamic.

The large equity market sell-off has led to questions about what changes we are making to the portfolio. The economy’s more cyclical areas will no doubt feel the impact of the sudden demand shock. And for many financials, the dual headwinds of lower interest rates and rising credit costs will present near-term challenges. However, as always, we are focused on long-term, normalized business outlooks and the associated expected returns of an ownership stake in a business. Through that lens, we believe that, despite the sudden near-term challenges facing our economy, the vast majority of businesses owned (i.e., longs) in the portfolio will eventually recover to more normalized operations and fundamentals. Given that long-term mindset, many stocks have become much more attractively priced. In short, expected long-term returns look quite attractive.

That said, due to the unique and somewhat unprecedented nature of a pandemic-driven shock to the system, we acknowledge a wider range of potential outcomes for many businesses. Therefore, though we meaningfully increased a few select holdings while also initiating new positions in a few higher quality companies, we have been somewhat tempered in the overall pace of growing our gross long exposure. Additionally, during these types of sharp market declines, we look for companies whose shares are typically in the “just too expensive” bucket but have become attractively valued on an absolute basis. New long positions in Visa, Mondelez and Sherwin-Williams are examples of terrific businesses that were available at what we viewed as reasonable or better prices. In sum, we are maintaining significant
exposure to cyclically sensitive areas which we believe represent substantial upside over the next few years while also adding high quality franchises not often available at sufficiently low valuations.

Meanwhile, there has been a more meaningful change to the short side of the portfolio as we trimmed or covered many positions as they fell toward our estimates of intrinsic value. The largest reductions came in the consumer discretionary and financials sectors and the overall result was a decline in the gross short exposure. This decrease, combined with flattish long exposure led to an increase in net exposure, which stood just above our long-term average of 60% at quarter end.

While we do not know when the economy will fully recover and when the world will get back to normal—or what that normal may look like—we do believe that the benefits of social distancing, along with widespread testing and therapeutic developments will play a large role in dictating the pace at which economic activity resumes. Until progress is made on those fronts, and until the spread of COVID-19 slows meaningfully, we expect elevated levels of volatility to continue. Though the causes have been different, we have seen similar periods of volatility in the past. Times like these can be extremely difficult, but we believe they underscore the importance of a long-term mindset. We remain focused on individual business analysis, comparing price and value, and prudently using volatility to take advantage of developing opportunities the market presents.

**Business Update**

We announced in early April that Nate Palmer has been elevated to co-portfolio manager alongside Chris Bingaman, replacing Jason Downey who is leaving Diamond Hill. Jason joined Diamond Hill in 2002, became assistant portfolio manager on the strategy in 2017, and co-portfolio manager in 2018. Jason is a talented analyst and an even better person, and he will be missed. Fortunately, we have a deep pool of talent on the investment team, and we have always considered succession planning crucial to Diamond Hill’s long-term success. Nate joined Diamond Hill in 2009 on the research team, and he has been the sector leader for our information technology and telecommunication services team since 2012. He became an assistant portfolio manager on the Long-Short Fund in 2018 and has since worked very closely with the team, collaborating and providing insight into positions across the portfolio. We are well-prepared for a seamless transition to continue managing the portfolio and delivering value-added investment results for clients.

Chris Bingaman, CFA     Nate Palmer, CFA

*The views expressed are those of Diamond Hill as of April 2020 and are subject to change. These opinions are not intended to be a forecast of future events, a guarantee of results, or investment advice.*

The Russell 1000 Index is an unmanaged market capitalization-weighted index comprised of the largest 1,000 companies by market capitalization in the Russell 3000 Index, which is comprised of the 3,000 largest U.S. companies by total market capitalization. The Russell 1000 Value Index is an unmanaged market capitalization-weighted index measuring the performance of the large cap value segment of the U.S. equity universe including those Russell 1000 Index companies with lower expected growth values. The Russell 1000 Growth Index is an unmanaged market capitalization-weighted index measuring the performance of the large cap growth segment of the U.S. equity universe including those Russell 1000 Index companies with higher expected growth values. These indices do not incur fees and expenses (which would lower the return) and are not available for direct investment.
As of March 31, 2020, the Diamond Hill Long-Short Fund owned equity shares of Alphabet (3.7% - long), Microsoft (2.8% - long), Facebook (2.8% - long), Visa (1.5% - long), Mondelez (1.4% - long), and Sherwin-Williams (1.4% - long).

The holdings identified do not represent all of the securities purchased, sold, or recommended for the adviser's clients. The reader should not assume that an investment in the securities identified was or will be profitable.

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Disclosures